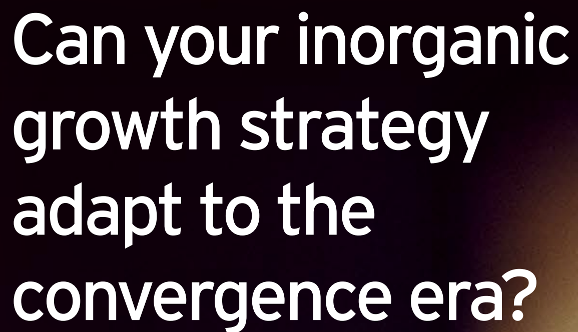


Can your inorganic growth strategy adapt to the convergence era?

Executing transactions amid high valuations and uncertainty in a rapidly changing TMT landscape

The better the question. The better the answer.
The better the world works.

"M&A has become an imperative. Gone are the days when M&A was an occasional option for building great TMT companies. The relentless pace of technology and business model disruption now requires M&A to be a continuous and ongoing element of any effective TMT strategy."

Clarence Mitchell
EY Global TMT Strategy Leader
Advisory Services

Overview

Business model change and still-rising competition fuel TMT M&A

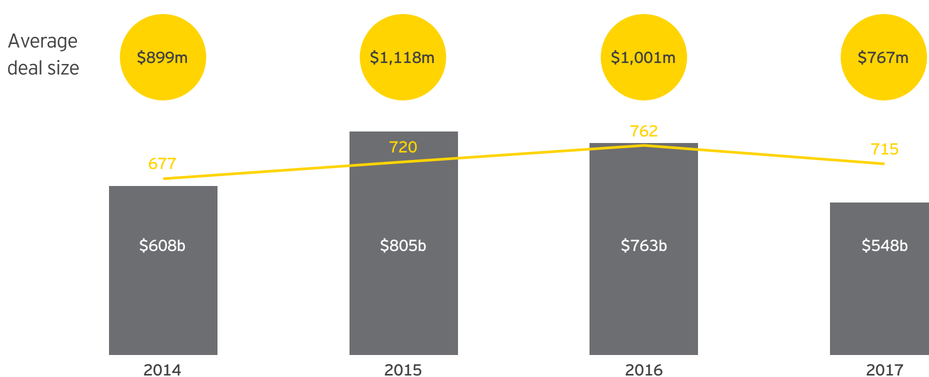
Technology, media and entertainment, and telecommunications (TMT) companies' business strategies are converging — and in flux. TMT is transforming rapidly, amid great uncertainty, as relentless innovation powers the development of new services and business models while often creating faster or lower-cost ways of doing what's possible today.

From 2014 through 2016, TMT M&A values soared, witnessing three straight years of more than 100 deals valued at over $1 billion – and 2017 just missed that level, with 95 $1 billion-plus deals. Though 2017 TMT dealmaking remained strong by historical standards, it slowed because of uncertainty (geopolitical, tax policy, regulatory), the slowing of outbound deals from China, and the need to pause and digest deals done in prior years.

The findings of EY's 17th *Capital Confidence Barometer*, however, give us reason to be bullish about TMT M&A to come. Over half (56%) of respondents indicated intent to pursue acquisitions in the coming year. Industry leaders are actively utilizing M&A as a catalyst to drive growth and transformation; we anticipate more industry-shaping (and reshaping) deals just beyond the horizon.

So what is driving TMT M&A today? Several macro trends are at play that tend to lead large TMT companies to seek even greater scale, deeper customer knowledge and comprehensive end-to-end solutions while pushing smaller firms toward niches in a particular value chain. The top two rationales driving TMT deals since 2014 highlight the drive for solution depth, breadth and scale (see Figure 2, page 4).

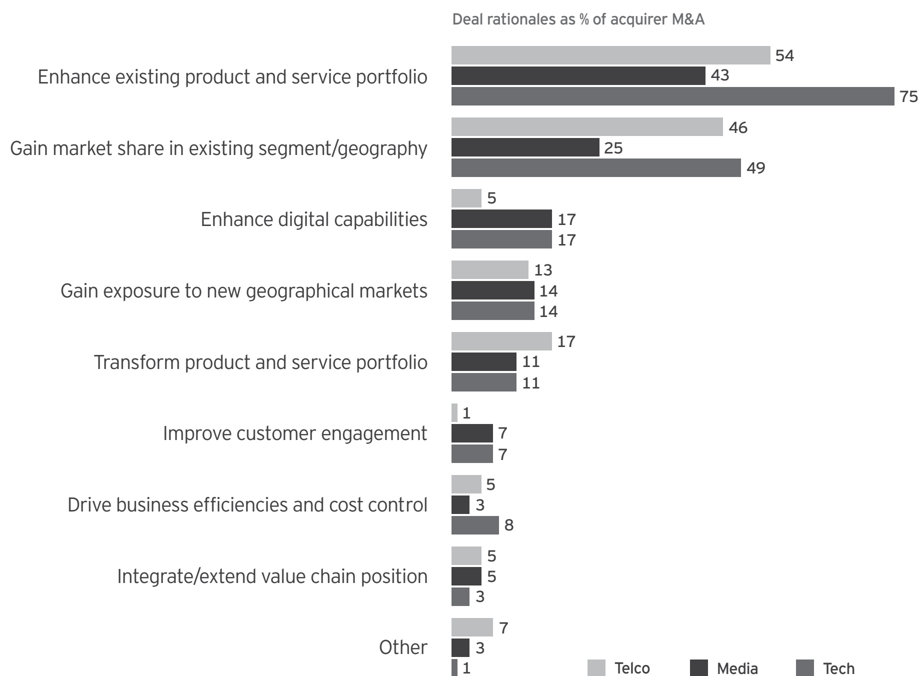
Figure 1: TMT announced deals 2014–17



Total: 2,874 announced M&A disclosed value of US$50m+

Deal value — Deal volume

Figure 2: Global TMT M&A deal drivers 2014–17



A key theme emerging in recent years is a broadening of the M&A competitive landscape. Gone are the days when there was a clear profile of the likely acquirer for a potential target. TMT companies are now attractive targets for buyers across the TMT sectors, as well as increasingly for private equity (PE) firms and non-TMT companies alike. PE has played a particularly notable role — the number of $1 billion-plus TMT acquisitions with PE sponsors doubled from 2015 to 2016. Given the record levels of dry powder and increasing willingness to pay higher valuations, we expect that competition from PE will continue to be a reality for would-be TMT acquirers throughout 2018 and beyond.

Convergence along many dimensions

To paraphrase venture investor Marc Andreessen, technology companies are "eating" the world economy. But hang on: at the same time, the rest of the world wants to "eat" technology, too.

In addition to the trends driving overall TMT M&A, there are specific trends driving cross-sector convergence – both within and outside TMT. "There's hardly a company left that doesn't think technology is going to be core to their ability to succeed in the marketplace," notes Clarence Mitchell, EY Global TMT Strategy Leader. Hence, we're seeing deals such as Ford's $1 billion investment for a majority of early-stage startup Argo AI, Walmart's $3.3 billion acquisition of Jet.com, Verizon's multiple deals for a range of Internet of Things (IoT) targets and – in the other direction – Amazon.com's $14.6 billion acquisition of Whole Foods Market.

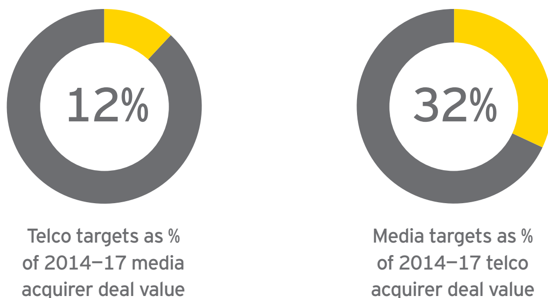
But that bidirectional megatrend isn't the only catalyst for "convergence deals" (see sidebar, adjacent) among TMT's three sectors. There's also the "re-merger" of content and distribution, leading to convergence among media and entertainment (M&E) and telco; the insurgence of tech companies into M&E, with large content appetites (and budgets) of their own; and tech companies' appropriation of telco customer demand with apps and services that, ironically, rely on telco network investments.

Convergence deals

"Convergence deals" encompass two types of growth-seeking M&A that have grown in recent years to become a core component of the TMT growth agenda.

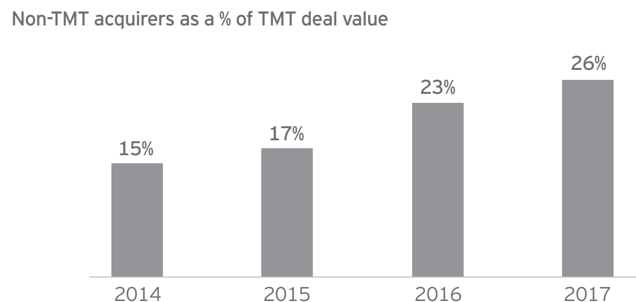
- **Future-growth convergence:** acquisitions of small, often private, venture-backed startups to position for anticipated future high-growth markets. Targets typically possess strategic technology elements, potentially disruptive digital business models, extremely hard-to-find talent or some combination of the three.
- **Immediate-growth convergence:** larger-scale acquisitions to achieve more immediate growth by targeting adjacent industries. Targets typically are incumbents operating businesses that can extend from, or leverage the use of, the buyer's core business or infrastructure, complementing the buyer's existing revenue model.

Figure 3: TMT convergence is ramping up significantly



Is true vertical integration in the cards in TMT?

Figure 4: Deal flow between non-TMT and TMT is increasing



Will non-TMT players be key competitors for assets in the future?

Take, for example, the radical changes to the content distribution model that have transpired in recent years. "Technology has made it possible to facilitate convergence offerings — especially the emergence of wireless technologies as potential contribution platforms," says Axel Majert, EY Global Telecommunications Sector Leader for Transaction Advisory Services. Customers are no longer married to the traditional linear value chain and can select from a range of alternatives. Says Majert, "the new distribution paradigm enables customers to directly access content producers, aggregators and distributors, in part driving these forms of convergence deals." As mobile technology continues along its S curve, TMT convergence deals will be required to address content delivery on the next platform — and the cycle continues.

Our analysis points to three key drivers behind TMT convergence deals in recent years:

- **Outrunning consumer behavior** — While most TMT companies struggle to keep up with shifting consumer behavior, convergence dealmakers must keep a particularly keen eye out to stay in sync. One example comes from the triple- and quad-play bundles emerging from convergence around multichannel video program distributors (MVPDs), telco fixed and mobile operators, and content.
- **Verticalization** — M&A can enable the integration of a complete value chain aligned to customer demand for a particular comprehensive end-to-end solution. Verticalization represents a merging of value chain capabilities alongside a drive to tailor services to industry-specific customers.

Consider IoT; its promise is to deliver outcomes such as fitness, for example, as opposed to an activity-tracking device. Delivering the end-to-end fitness solution requires that device, but more: it must be linked to extensive software, analytics and multiple databases in the cloud, all oriented around the customer's goal.

- **Race for data** — Another motivation for deal activity is the potential to launch new revenue-generating models built on big data analytics capabilities. Artificial intelligence (AI) systems enable monetization of data assets that was not possible just two years ago. In TMT, combining customer data with existing content or advertising assets can yield significant revenue growth through better targeting and personalization.

> "Owning demand — the customer relationship — not the supply is the key to verticalization. You have to own the customer by providing a total solution or own a key piece of the value chain contributing to someone else's solution."
>
> Will Fisher
> EY Global Media & Entertainment Sector Leader
> Transaction Advisory Services

Partnerships rising

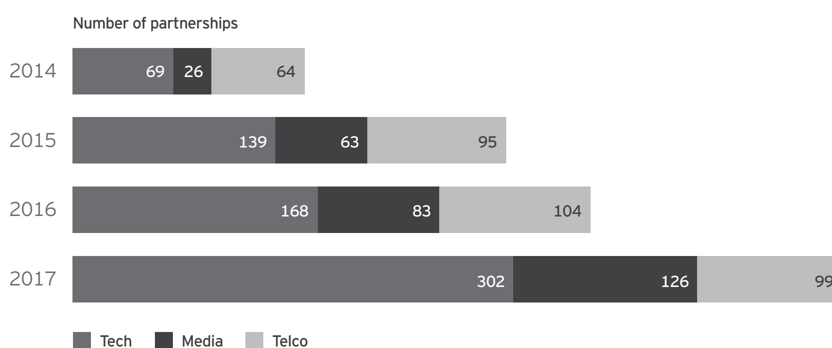
As potential future business models multiply and evolve, complexity, convergence and the need for scale and speed to market are all accelerating each other. A wise TMT company needs more bets on the table than can be covered by M&A alone.

That's why one of the clearest data points to emerge from our research is the rapid growth of strategic alliances and partnerships across all three TMT sectors. Partnerships soared at a 35% compound annual growth rate (CAGR) in tech, telco and M&E from 2014 through 2017 to an aggregate 527 deals (see Figure 5). On a year-over-year basis partnering announcements almost doubled in 2017 for tech companies, media partnership deals jumped 52% and telco partnership deals declined 5%.

Beyond the data, EY has seen a qualitative change in the nature of TMT partnerships. "Many past partnerships were looser affiliations," says Mitchell. "Alliances today in TMT are frequently more significant and tightly integrated. Partners are sharing data, jointly developing products and offerings, and actively building ecosystems and platforms. There is more real operational integration between partners."

Unlike M&A, partnering resources can be adjusted up or down over time. That's critical in the current fast-changing environment, where business strategies can shift rapidly. "Partnerships are ideal for organizations looking to dip their toes in the water without a full commitment," notes Mitch Berlin, EY Americas Operational Transaction Services Leader.

Figure 5: Global TMT strategic partnerships by sector



Getting convergence right

TMT companies face a multitude of tough questions when evaluating convergence options:

1. **What types of technology and content would best complement our growth strategy?**
2. **Where are the best acquisition and partnership opportunities?**
3. **What deals might head off disruption from below or orthogonal competition from out-of-sight?**
4. **Which offer the largest and fastest revenue growth?**
5. **Which lead to the best business model of the future?**
6. **How can we use new data assets in disruptive revenue-generating models?**

These are hard questions with few clear answers. Even after determining the optimal strategic direction, TMT companies must then choose among a wide range of inorganic growth paths to achieve their convergence goals, from traditional M&A to incubation, corporate venturing and partnerships.

Common challenges

There are three common root causes for failed M&A: bad strategy, overpayment and botched integration. TMT convergence deals must contend with these issues, too — and may find them exacerbated by a lack of foundational knowledge in the target business.

"First of all, how do you know what you're buying or even how to appropriately value a company that is so far outside of what you do every day?" asks Berlin. "And what does effective integration look like? Where do you fall on the spectrum between complete integration and leaving it stand-alone? There is no one right answer to these questions."

Target selection

Generating a strong acquisition pipeline and pursuing the right targets are paramount to any inorganic growth strategy. In today's TMT landscape, with hyper-fluid business models and changing consumer behavior, this can be particularly challenging. So where should TMT companies place their bets? Majert notes, for example, that, "Telcos have an incredibly broad range of convergence options to choose from in their M&A. Some are going into content and advertising, others are extending into enterprise cloud services, and some have gone quite deep into verticals."

Valuation

In today's competitive TMT M&A market, getting the right asset for the right price requires more careful analysis than ever. Companies can optimize their valuation by considering — and quantifying — different sources of value from each deal. Take, for example, a small, loss-making tech startup with significant talent and intellectual property (IP). An EBITDA (earnings before income, taxes, depreciation and amortization) multiple approach alone will not inform the true value of the business. A thoughtful acquirer will separately place value on the talent, IP and tax attributes that could generate value from the deal.

Effective integration

As the sheer pace of TMT change accelerates, there has never been more pressure to integrate quickly — and to show results. But the increasing need for merger integration speed faces a counterpoint: many TMT deals require new integration thinking to drive deal value — and certain deals may require throwing away the traditional integration playbook entirely. Setting aside deal size, merger integration challenges generally increase in proportion to the difference between the acquirer's and target's legacy businesses.

"Integration strategy is an essential component of assessing the potential benefits of any deal. This is especially true for M&A in TMT where the pace of industrial change requires seamless execution long past closing," says John Harrison, EY Global Media & Entertainment Leader. Whether the aim of the deal is as traditional as cost takeout or as nuanced as verticalization, companies need to design tailored integration plans that can be mobilized — fast.

Let's start with traditional TMT consolidations oriented around scale and cost-out synergies. While the old playbook may still hold true for many of these deals, the timeline must be accelerated to enable realization of synergies immediately following the deal's close. Using "clean rooms" and advisors, companies can have detail-level integration and synergy capture plans in place before the deal's close and report realized value immediately after. In cost synergy-driven transactions, time is, literally, money.

When pursuing a more transformative acquisition outside an organization's core business, companies must step back and think about the degree of integration that will best enable the deal's value drivers, as well as the ideal speed with which to achieve it. In a deal aimed at strategically growing a company's portfolio through the addition of a wholly new business unit or geography, it may make sense to take a measured approach to integration and get to know each other a bit before designing the target operating model while still capitalizing on short-term win opportunities.

In convergence deals in particular, the key to integration is twofold:

- Guarding the target's operation so that the things you value most about it — its ability to innovate, its culture, its connection to the market you're trying to enter — don't get damaged
- Effectively incentivizing target leadership and employees to accelerate value creation by all those things you value about the target

The critical difference to keep in mind for convergence deals is that you're unlikely to realize the value of the deal without adopting important new business behaviors. Behavioral and process changes could include identifying and incentivizing the relatively few business behaviors that truly make a difference to a successful deal outcome; operating model changes that promote the key business behaviors; and modular integration, because not everything needs to be integrated as quickly as possible — and perhaps some functions shouldn't be integrated at all. We recommend determining the different level of integration function by function.

"The big thing in convergence deals is to design a winning operating model — one that bridges the gap between the two corporate cultures in a way that aligns everyone behind the strategic goals of the new organization," says Brian Salsberg, EY Americas M&A Integration Leader.

For example, if rapid time to market is a strategic goal, then a key business behavior to cultivate through the operating model would be explicit clarity as to who in the organization has decision rights on product design, pricing and marketing issues, and how quickly those decisions must be made. In this case, defining short-term sales growth targets may not even apply, especially for still-embryonic markets such as AI and IoT, where all the uses of the technology may not yet be clear and targets may not have any real revenue to begin with.

Divesting to grow

With advancing technology constantly making new things possible, company building is no longer a straight-line pursuit.

The same innovation driving TMT M&A and partnering virtually guarantees that TMT company business strategy will continue to change. Companies must continue to evaluate their portfolios to determine which assets will be accretive to their future ambitions and which will not.

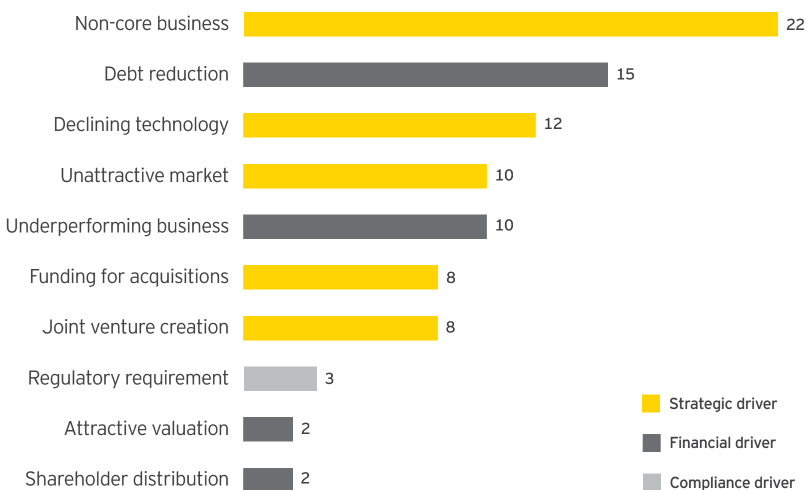
"For diversified TMT companies, divesting businesses that no longer fit with the core strategy or have lower growth potential frees capital and management resources to invest in more attractive areas," says Harrison.

Berlin points out that "serial divesters" are typically among the "healthiest" companies: "Serial divesters have a model in place and treat their business units almost as if they were a private equity firm managing portfolio companies in a fund. They'll analyze their portfolio quarterly or semiannually, and make disciplined decisions about the value of a unit to their organization, and whether it might be more valuable to a third party."

Recent EY research reinforced this idea, finding that fast-growing TMT companies performed capital budgeting processes more often, compared with both slow-growing TMT companies and fast-growing non-TMT companies.[1]

In short, in the era of convergence and technological disruption, TMT companies need to regularly review their portfolios and be willing to take bold action based on the findings of those reviews.

Figure 6: Business and technology imperatives drive the TMT divestiture rationale



Note: aggregate deal value is $153b, average deal value is $3.1b

[1] Barak Ravid, Samuel Leiter and Nina Lapachet, "Can the capital allocation process be a competitive advantage?" EY-Parthenon website, parthenon.ey.com/po/en/perspectives/can-the-capital-allocation-process-be-a-competitive-advantage.

Conclusion

Technology-enabled disruption, business model uncertainty, record-high equity markets and cross-sector convergence are in the nature of the TMT industries today. You can't escape them.

Venture investment is seeding thousands of startups driving ongoing cycles of disruptive technologies, while private equity sponsors play an increasingly significant role in the TMT M&A landscape.

Success accrues so rapidly in the world of TMT that companies not first or second to any market risk irrelevance.

Meanwhile, the uncertainties make decision-making, especially around very large capital allocation decisions such as M&A, very challenging, indeed. What is more, TMT M&A success today sometimes means discarding the old merger integration playbook. Driving deal value at this transformational time requires new thinking and new approaches.

But ...

Does anybody think the pace of change in TMT will get slower from here?

We don't think so. Instead, TMT companies can look to M&A and partnerships for that missing strategic link to complete an end-to-end solution, for scale through consolidation, geographic expansion, convergence deals or the key digital transformation capabilities they need.

For a more detailed review and further discussion of the data and analysis behind this report, contact our article contributors named on the back page.

M&A and partnerships methodology
Our M&A data covers 2,874 announced deals worldwide with deal values of $50 million or greater from 1 January 2014 to 31 December 2017, and is based on EY analysis of data from sources including The 451 Group, S&P Capital IQ, ThomsonONE.com and Mergermarket. Deal drivers have been evaluated through EY analysis of the announced deals during this period.

The partnerships data is based on EY analysis of strategic partnerships announced by 82 leading companies representing a total of 15 TMT subsectors, selected on the basis of overall and segment revenue size. Partnerships announced between 1 January 2014 and 31 December 2017 were evaluated. Vendor/reseller agreements and IP/content licensing arrangements involving unilateral flow of money are excluded from the partnership assessment performed by EY. Incubator research is also based on this universe of 82 TMT companies.

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